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JAN 15 1998

No third party contact **INTERNAL REVENUE SERVICE**
501.19-00
4401.00-00 **NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**
512.00-00
District Director
Key District Office (EP/EO)
Information Copy: Chief, EP/EO Division
OP:E:EO:T:4
Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Group Exemption Number:

Years Involved:

Date of Conference:

LEGEND:

B -
C -
D -
E -
F -
G -
H -

b -

ISSUES:

1. Whether, under the circumstances described, the Post meets the requirements for continued recognition of exemption as an organization described in section 501(c)(19) of the Internal Revenue Code with deductibility of contributions under sections 170(c)(3) and 2522(a)(4).

2. If the Post remains exempt under section 501(c)(19) of the Code, whether bar/canteen income from nonmembers and paying guests, room and

parking lot rental income, and instant bingo and other gambling revenues constitute unrelated business taxable income under section 512(a)(1).

3. Whether the Post's sale of pull-tabs results in its being liable for the gambling excise taxes under sections 4401 and 4411 of the Code.

FACTS:

The Post is a veterans' organization that was incorporated on b. The Post is exempt under section 501(a) of the Code as an organization described in section 501(c)(19) and has deductibility of contributions under sections 170(c)(3) and 2522(a)(4). The Post is included in the B group exemption. The Post's primary purposes include perpetuating America, preserving the memories of our veterans, and promoting social welfare. Post membership is limited to persons described in the B Constitution. The Post has 400 members.

The Post's community activities include B baseball, Boy Scouts, hospital assistance, an epilepsy program, Boys State, the F society, Alzheimer's Walk, Honor Guard, Special Olympics, Cerebral Palsy, Eye Bank, assisting the needy, and Veterans' Day and Memorial Day Ceremonies. In 1991 2,103 volunteer hours were spent on community activities, in 1992 - 2,252 hours, and in 1993 - 2,392 hours. Post activities include the operation of a bar and canteen seven days a week, 8-14 hours per day, with "happy hour" held five days a week. Pull-tabs are sold at the bar. The Post also maintains a stamp machine that sells pull-tabs. The Post operates three poker machines and a game room. The H room is rented to Post members and the public. Four parking spaces are rented to an adjacent business. Other activities include fundraisers to support local youth organizations, flag donations and a baseball team.

The bar, canteen, poker machines, pull-tab sales and game room activities are available to Post members and guests, D and F members, as well as members of other B posts and members of other unrelated veterans' groups and posts. The canteen, where sandwiches are served, is open to all veterans. Members of the Post sign in guests, while members of other posts sign themselves in. The facilities do not appear to be open to the general public except for the members of a local G post which does not have a post home. There is a key entry to the facility, and the rules for guests are posted on the door.

The Post has operated poker machines since June 1990 when four video poker machines were loaned to the Post by a member at no cost. These machines were donated to the Post by the member on March 11, 1994. The Post currently

has three machines. The club manager is the only person who has keys to the poker machines, vending machines and game room. He counts funds daily, subtracting payouts for the last business day and recording the netted figure in the Post's receipts book. Under state law it is lawful to operate poker machines for amusement only; it is unlawful to operate poker machines and make payouts. Credits earned by players at the machines can be cashed in at the bar by a barmaid who maintains a ledger and records the date, names and amounts paid out. After amounts are paid out, the barmaid clears the credits on the machines. No records of payments by the barmaids on the poker machines were kept for years prior to tax year 1993. The morning and afternoon barmaids use the same register. At the end of the workday, the register tape, winning pull-tabs and recordings of poker payouts are placed in the office safe in a cash box. Receipts and payouts are totalled and recorded in the daily sheets for both morning and afternoon barmaids by the club manager.

The Post's representatives stated that pull-tabs are sold in case lots with a set amount of winning cards so that it is possible to match proceeds with cases. The vending machines, pool table and juke box all have counters. Amounts earned per counter are reconciled with bank deposits.

The Post has filed Forms 990 for all years under examination. Forms 990-T were filed for all years under examination relating to receipts from poker machines, hall rentals and parking space rentals. The Post reported the "netted" receipts on the Forms 990. The receipts from the pull-tabs, tip jar receipts, vending machine and emblem sales were reported as contributions, and the poker machine receipts were reported in "gross sales." The Key District Office ("KDO") noted that total revenues were understated on the Forms 990 filed.

An auxiliary, D, supports the Post and is separately chartered by the B Auxiliary National Constitution and By-Laws. D is exempt under the group ruling issued to E, which issues membership cards to members of D. The Auxiliary's members are permitted to use the Post's facilities and participate in the programs and services of the Post. They cannot vote at Post meetings, hold positions as a Post officer, or serve or be appointed to a Post committee. Revenues generated are recognized as Post income.

F is a society within the Post that is separately chartered, but has no Employer Identification Number. Members of F must be a son or grandson (by blood, marriage or adoption) of a war veteran. F's members cannot vote at Post meetings, hold positions as Post officers or serve on Post Committees. F has no authority to assume contractual obligations. F's members participate in Post programs and services and have full use of the premises. F's members have

keycards which provide building access. Dues are collected by the Post and remitted to the state and national office. E's income and expenditures are reported by the Post on Form 990. The Post's representatives stated that most of E's members are veterans who are also members of the Post (dual members), while some members of E are young people under the age of 18.

ISSUE 1 - LAW:

Section 501(c)(19) of the Code provides for the exemption from federal income tax of a post or organization of veterans of the United States Armed Forces if such post or organization is:

(a) organized in the United States or any of its possessions,

(b) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets, and

(c) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(19)-1 of the Income Tax Regulations provides that to be described in section 501(c)(19) of the Code an organization must be operated exclusively for one or more of the purposes listed in that section. Section 1.501(c)(19)-1(c)(8) of the regulations lists as one of these purposes the provision of social and recreational activities for the organization's members.

Section 1.501(c)(19)-1(c) of the regulations provides that an organization described in section 501(c)(19) of the Code must be operated exclusively for one or more of the following purposes: (1) To promote the social welfare of the community as defined in section 1.501(c)(4)-1(a)(2) of the regulations, (2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans, (3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States, (4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors, (5) To conduct programs for religious, charitable, scientific, literary, or educational purposes, (6) To sponsor or participate in activities of a patriotic nature, (7) To provide insurance benefits for their members or dependents of their members or both, or (8) To provide social and recreational

activities for their members.

In Senate Report No. 92-1082, 92nd Cong. 2d Sess., Congress stated that for purposes of section 501(c)(19) of the Code, "substantially all" means 90 percent. Therefore, of the 25 percent of the members that do not have to be past or present members of the Armed Forces of the United States, 90 percent have to be cadets, or spouses, etc. Thus, only 2.5 percent of a section 501(c)(19) organization's total membership may consist of individuals not mentioned above.

Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe.

Section 6033(a)(1) of the Code provides, except as provided in section 6033(a)(2), every organization exempt from tax under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

Rev. Rul. 59-95, 1959-1 C.B. 627, concerns an exempt organization that was requested to produce a financial statement and a statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provisions of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

ISSUE 1 - RATIONALE:

An organization described in section 501(c)(19) of the Code carries out activities in furtherance of its exempt purposes only when the activities are exclusively in furtherance of the purposes listed in section 1.501(c)(19)-1(c) of the regulations. Among these purposes is the provision of social and recreational activities for its members. Therefore, when a veterans' organization described in section 501(c)(19) provides social and recreational activities for its members, or for guests whose expenses are paid by members, it is engaged in activities in furtherance of its exempt purposes.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(19)-1(c) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 50 percent of its gross receipts are derived from sales transactions (e.g. restaurant and bar sales), the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(19) activities. However, this presumption may be rebutted. All facts and circumstances must be reviewed to determine whether or not the organization primarily engaged in section 501(c)(19) activities.

Here, the Post has presented evidence that during the years under examination it engaged in activities that were in furtherance of exempt purposes under section 501(c)(19) of the Code. Such activities include patriotic activities, social activities, membership meetings, and various charitable and social welfare activities.

During the time of the examination there was no permanent mechanism in place to maintain records to distinguish between income from "veteran" members, members' families, bona fide guests, auxiliary members and non-veterans in activities such as the bar/canteen, gambling and social activities. However, the information provided indicates that only limited income would have been from nonmembers or unrelated sources. Under these circumstances, members of the general public, if any, using the Post's facilities may raise an unrelated business income tax ("UBIT") issue (see infra), but would not adversely affect the Post's tax-exempt status under section 501(c)(19) of the Code.

Whether members of the D auxiliary and the E society should be considered members of the Post for purposes of section 501(c)(19) of the Code must be considered to determine if the Post meets the membership requirements of section 501(c)(19). The members of an IRC 501(c)(19) auxiliary that is related to a Post are not considered members when the auxiliary is a separate organization. Here, the D auxiliary is separately formed and is recognized as tax-exempt, therefore the auxiliary members are not considered members of the Post.

The information presented indicates that although the E society has its own charter, it is not otherwise independently formed and operated as a separate organization, but is an activity within the Post. For purposes of the percentage tests under section 501(c)(19) of the Code, adult members of the E society should be treated as members of the Post. Members of the E society who are under 18 years of age should not be considered members of the Post, as this is a youth program that furthers the Post's exempt purposes. Since most of the members of

the F society are also members of the Post (dual members), this would not adversely impact the Post's exemption under section 501(c)(19), as non-veteran members of the F society comprise less than 2.5% of the Post's total membership. Therefore, the Post would fall within the membership limitations under section 501(c)(19).

Although the Post's completing of its Forms 990 for the years in question was not entirely sufficient, we believe the Post has generally maintained the records required under section 6001 of the Code to determine that it meets the requirements for continued recognition of exemption under section 501(c)(19). Unlike the situation described in Rev. Rul. 59-95, supra, any failings of the Post with respect to recordkeeping and filing returns do not rise to a level that would support revocation of exemption under section 501(c)(19). The KDO may wish to consider whether an inadequate records notice may be appropriate under these circumstances.

ISSUE 1 - CONCLUSION:

Based upon the information presented, the Post meets the requirements for continued recognition of exemption as an organization described in section 501(c)(19) of the Code, with deducibility of contributions under sections 170(c)(3) and 2522(a)(4).

ISSUE 2 - LAW:

Section 511(a) of the Code provides for the taxation of unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code provides, in part, that the term "unrelated business taxable income" means the gross income derived by an organization from any "unrelated trade or business" (as defined in section 513) regularly carried on by it, less certain deductions, and computed with the modifications provided in section 512(b).

Section 512(b)(3) of the Code excludes rents from real property and all rents from personal property leased with such property if the rents attributable to such personal property are an incidental amount of the total rents received. The exclusion does not apply if more than 50% of the lease is attributable to personal property, or if the determination of the amount of such rent depends on the income or profits derived by any person from the property leased.

Section 1.512(b)-1(c)(2) of the regulations excludes rents from real property, and rents from personal property leased with real property, if the rents attributable to personal property generally do not exceed 10 percent of the total rents from all property leased.

Section 1.512(b)-1(c)(5) of the regulations states that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its exemption under section 501. The term does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.

Section 513(c) of the Code provides that for the purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 513(f) of the Code provides that the term "unrelated trade or business" does not include the conduct of certain bingo games. In 1984, Congress passed Pub. Law 98-369, sec. 311(a), subsequently clarified in 1986 by Public. Law. 99-514, sec. 1834, to apply the same treatment to certain "other

games of chance" that were then in operation and conducted under a state law enacted on April 22, 1977, subsequently amended to October 5, 1983. This law applies only to gaming activities conducted in the State of North Dakota.

Announcement 89-138, 1989-45 I.R.B. 41, was published by the Service as a reminder to tax-exempt organizations that income from the public conduct of certain bingo games and other gaming activities may be subject to the unrelated business income tax imposed by section 511(a) of the Code. The Announcement recaps the rules applicable to this area. Currently, income from the conduct of charitable gaming activities, other than bingo, is excluded from the definition of unrelated business taxable income only in the State of North Dakota.

Rev. Rul. 69-178, 1969-1 C.B. 158, provides that income from a short term lease that included utilities and janitorial services was rent within the meaning of section 512(b)(3) of the Code and should be excluded in determining unrelated business taxable income.

ISSUE 2 - RATIONALE:

Although the Post is exempt from federal income tax under section 501(c)(19) of the Code, it is still subject to tax on income derived from any unrelated trade or business regularly carried on by it. The Post is subject to the unrelated business income tax on such income if three conditions are present: (1) the income is from a trade or business, (2) the trade or business is regularly carried on, and (3) the trade or business is not substantially related to the exercise or performance by the Post of its exempt function.

The sale of goods or performance of services for the production of income is a trade or business, even when undertaken by a tax-exempt organization. The Post derives profits from activities such as the sale of food and beverages, gambling activities, room and parking lot rentals, and displays the required profit motive. Such activities, therefore, constitute a trade or business for purposes of section 513 of the Code.

A trade or business is considered to be regularly carried on when the activity is conducted with sufficient frequency and continuity to indicate a continuing purpose of the Post to derive some of its income from such activity. The Post's activities occur on a very frequent basis and, therefore, these activities are regularly carried on.

Clearly, the Post's activities constitute a regularly carried on trade or business. The real issue here, however, is whether these activities are

substantially related to the Post's exempt purposes, and whether any of the exceptions contained in sections 512 - 513 of the Code are applicable. Before any activity can be considered substantially related, a nexus must exist between the goods sold or the services provided and the accomplishment of the Post's exempt purposes. If a nexus does exist, then the revenue generated from such activities will not be treated as unrelated business taxable income.

Section 1.501(c)(19)-1(c)(8) of the regulations lists the provision of social and recreational activities for its members as one of the appropriate exempt purposes of a veterans' organization. This provision permits a post to operate a bar or restaurant for its bona fide members. Any socializing or recreational endeavors sponsored or facilitated by a post should first and foremost focus on the bona fide veteran members. Use of a post's facilities by those other than such veterans needs to be closely scrutinized.

With respect to sales of food and beverages, gambling activities and hall and parking lot rentals, for purposes of section 501(c)(19) of the Code, revenues derived from bona fide members are not taxable, while amounts from the general public are subject to tax. Falling within the nontaxable category are bona fide guests, i.e., individuals who are accompanied by a bona fide member and who do not themselves pay for food, beverages, or gambling. Also coming within the nontaxable category are certain family members and relatives of the bona fide members, including spouses, children, grandchildren, parents, grandparents, and siblings. These categories of individuals are set forth in section 1.501(c)(19)-1(d)(2) of the regulations, which denotes the membership requirements for auxiliary units of veterans' organizations. Also, members of the Post's auxiliary units or societies would fall within the nontaxable category in computing unrelated business taxable income.

One question presented is whether the use of the Post's facilities by a member of the E society furthers the exempt purpose of the Post. As organized, the E society is an appropriate Post function and the use of the Post's facilities in most instances would be appropriate. Based upon the information presented, income from members of the E society would meet the substantially related test, as their activities are sponsored by the Post and further Post purposes.

Another nontaxable category consists of individuals who, although they are not members of the local Post, are members of other posts that are covered by the B group exemption. In accordance with this category, any bona fide member of a state or national B organization, or a local B post could partake of the social and recreational activities offered by the Post. Any revenues resulting from such activities would not constitute unrelated business taxable income because the

"substantially related" test under section 513(a) of the Code would be met.

On the other hand, the substantially related test would not be met where food, beverages, and gambling activities are made available to nonmembers of the Post, paying guests, members of the public, and members of veterans' organizations not part of B, such as G. Thus, providing goods and services to the foregoing categories of individuals does not contribute importantly to the accomplishment of any exempt purpose listed in section 1.501(c)(19)-1(c) of the regulations.

With regard to amounts derived from the H room rentals, the prior analysis is also applicable to the extent that use of the H room by members and individuals in other nontaxable categories would not be subject to tax. With respect to H room rentals that would otherwise be taxable, the question presented is whether such amounts constitute rent from real property that may be excluded from the computation of unrelated business taxable income under section 512(b)(3) of the Code. In connection with some of the rental activities, it appears that the Post may be providing food and beverage services that would result in these amounts not being treated as excludable rental payments. See section 1.512(b)-1(c)(5) of the regulations. Amounts from other rental activities, such as those involving no providing of services, do meet the requirements under section 512(b)(3) as rent from real property. In these instances, the Post appears to be similar to the organization described in Rev. Rul. 69-178, supra, which was paid only for the use of space. The Post's representatives have stated that parking lot revenues have been reported as unrelated business taxable income under section 512(a)(1). Also in accordance with section 1.512(b)-1(c)(5), such amounts would not be treated as rent from real property.

The aforementioned distinction between nontaxable members, et al., and taxable members of the public is also applicable to amounts derived from video poker machines and so-called "instant bingo." Thus, amounts attributable to video poker machines and instant bingo played by members of the Post would not be subject to tax, because such activities are substantially related to the accomplishment of social and recreational purposes set forth in section 1.501(c)(19)-1(c) of the regulations. The same conclusion would be reached, even if some gambling activities may violate state or local law. It should be noted that neither video poker machines nor "instant bingo" meet any of the exceptions in sections 511 - 513, such as the exception for "bingo" set forth in section 513(f). Therefore, amounts derived by the Post from individuals who fall within the previously described taxable categories constitute unrelated business taxable income. See Julius M. Israel Lodge of B'nai B'rith No. 2113 v. Commissioner, T.C. Memo 1995-439, aff'd 98 F.3d 190 (5th Cir. 1996).

ISSUE 2 - CONCLUSION:

A. There is no UBIT on income from members of the Post, members of its auxiliary and society, bona fide guests, members of other B Posts, and H room rentals that do not include food and beverage services.

B. Bar/canteen, pull tabs/instant bingo and video poker income from nonmembers, paying guests, members of the public, and members of unrelated veterans' organizations, such as G, is subject to UBIT.

C. Income from H room rentals to nonmembers where the rent includes food and beverage services, and parking lot rentals is subject to UBIT.

ISSUE 3 - LAW:

Section 4401(a) of the Code imposes (1) on any wager authorized under state law a tax equal to 0.25 percent of the amount wagered and (2) on any wager not authorized under state law a tax equal to 2 percent of the amount wagered.

Section 4411(a) of the Code imposes a special tax of $500 per year to be paid by each person who is liable for the tax imposed under section 4401 or who is engaged in receiving wagers for or on behalf of any person so liable.

Section 4411(b) of the Code substitutes $50 for $500 in subsection (a) in the case of (1) any person whose liability for tax under section 4401 is determined only under paragraph (1) of section 4401(a) and (2) any person who is engaged in receiving wagers only for or on behalf of persons described in paragraph (1).

Section 4421 of the Code provides that wagers include lotteries conducted for profit, but section 4421(2)(B) excludes from the term "lottery" any drawing conducted by an organization exempt from tax under sections 501 and 521, if no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual.

Tip jar and pull-tab games have been determined to be forms of lotteries. See Rev. Rul. 54-240, 1954-1 C.B. 254, and Rev. Rul. 57-258, 1957-2 C.B. 418. Also, they are considered "drawings" for purposes of the exclusion provided by section 4421(2)(B).

ISSUE 3 - RATIONALE:

Amounts wagered in drawings conducted by exempt organizations are not subject to wagering tax as long as no part of the net proceeds inures to the benefit of any private shareholder or individual. Generally under the rationale of Knights of Columbus Council #3660 v. United States, 783 F.2d 69 (7th Cir. 1986), raising substantial revenue from wagering activities open to the public for a long period of time to defray organizational operating expenses and to subsidize membership, recreational, and social activities constitutes private inurement. If the wagering activities are not open to the public, but are limited to members and bona fide guests, the use of the proceeds to defray operating expenses, etc. does not constitute inurement. Also see Rochester Liederkrantz, Inc. v. United States, 456 F.2d 152 (2d Cir. 1972).

To sustain an assertion of tax, the facts must show the source and disposition of the net proceeds from wagering. For example, if it is shown that wagers were accepted from nonmember/guest sources, the wagering proceeds were commingled with other bar or bingo revenue, and those proceeds were applied in part for general operating expenses or to subsidize the bar and food operations and in part for charitable purposes, a proportionate amount of the wagering proceeds could be deemed to have inured to the benefit of the members. If, on the other hand, the wagering revenue is separately accounted and is earmarked solely for charitable purposes, no inurement can be attributed to the wagering activities and no liability for tax arises. The facts as presented do not adequately demonstrate that the proceeds have not inured to the benefit of private individuals.

ISSUE 3 - CONCLUSION:

Based upon the above, the Post has not met the exception of section 4421 of the Code, as it has not shown that funds were not spent for operating expenses. The Post has not shown that inurement did not occur.

A copy of this memorandum is to be given to the organization. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

-END-